



## Memorandum

TO: HONORABLE MAYOR  
AND CITY COUNCIL

FROM: Richard Doyle  
City Attorney

SUBJECT: Ordinance to Implement New  
Heath Care Trust for Federated  
City Employees' Retirement Plan

DATE: May 13, 2011

### **RECOMMENDATION**

Consider an Ordinance amending Title 3 of the San José Municipal Code to add a new Chapter 3.52, and to amend Sections 3.28.380, 3.28.1980, 3.28.1995, 3.28.2030 and 3.28.2045 and add a new Section 3.28.385 to Chapter 3.28, for the purposes of establishing a new trust pursuant to section 115 of the Internal Revenue Code related to retiree health care benefit funding and payment of retiree health care benefits.

### **BACKGROUND**

The Federated City Employees' Retirement Plan (the "Federated Plan") pays 100% of the premium cost for the lowest cost medical plan (Health Benefits) and the costs of dental premiums (Dental Benefits) for certain retired members and other persons who receive retirement allowances from the Federated Plan. The premium payments are currently made through a medical benefits account established by the City Council under Section 401(h) of the Internal Revenue Code (IRC). The 401(h) account is funded by contributions made by the City and active employees.

Through fiscal year 2009, contributions to the Federated Plan's medical benefits account for Health and Dental Benefits for both the City and the participating Federated employees were based upon an actuarially determined percentage of employees' base salary sufficient to provide adequate assets to pay benefits when due over the next 15 years. In April, 2009, the City reached agreements with ABMEI, AEA, AMSP, CAMP, IBEW, MEF, and CEO to phase in to full funding of the annual required contributions (ARC) for the Health and Dental Benefits over a five year period. The ramp up to full funding specified in these agreements was also implemented for unrepresented employees. These agreements provide that the initial unfunded retiree healthcare liability will be fully amortized over a thirty year period so that it will be paid by June 30, 2039.

The agreements also provide that the five year phase-in of the ARC will not have an incremental increase of more than 0.75% of pensionable pay in each fiscal year for the employee contributions and the City cash contribution rate will not have an incremental

increase of more than 0.75% of pensionable pay in each fiscal year. Notwithstanding these limitations on incremental increases, the agreements further provide that by the end of the five year phase-in, the City and the members "shall be contributing the full Annual Required Contribution in the ratio currently provided" in the relevant sections of the San José Municipal Code.

Section 401(h) of the IRC is one vehicle that allows employee contributions for retiree health care benefits to be made on pretax basis, and allows earnings in the fund to accumulate tax free. However, as a condition of this favorable tax treatment, IRC Section 401(h) limits the total amount of contributions that can be made to the medical benefits account. In order to ensure that the IRC contribution limit would not affect the ability to implement full funding of the ARC, the April 2009 agreements with the bargaining units provided that the City would establish a qualified trust that would become the sole funding vehicle for Federated retiree healthcare benefits.

On February 10, 2011, the Federated City Employees' Retirement Plan Board of Administration received a report from its actuary, Cheiron Inc., indicating that projected contributions to the Plan's medical and dental benefits account were expected to exceed the limits set forth in Internal Revenue Code Section 401(h) during the fiscal year ending June 30, 2012. The Plan's actuary further advised that once the limit is reached, future 401(h) contributions would be limited to one-third of the pension normal cost contributions.

Earlier this year, the City Attorney's Office engaged Ice Miller, LLP, as outside tax counsel, to assist with preparation of trust documents for both the Federated Plan and the Police and Fire Department Plan. The ordinance that has been drafted for the Council's consideration includes Municipal Code amendments to implement a qualified trust as contemplated by the April 2009 agreements with the bargaining units. The Federated Trust Ordinance is being presented at this time in order to have a trust in place to receive contributions before the 401(h) limit is reached for the Federated Plan. Separate ordinances for Police and Fire will be presented to the City Council prior to the end of the fiscal year. The City Attorney's Office has been advised by staff that the limit on funding the 401(h) account for the Police and Fire Plan is not expected to be reached in the next fiscal year.

## **ANALYSIS**

The draft ordinance would establish a new trust fund pursuant to Section 115 of the internal Revenue Code. The ordinance as drafted contains the following key provisions:

- The new Trust Fund would be administered by a Board of Trustees composed of the Board members of the Federated City Employees Retirement Plan.

- City contribution for retiree health care would begin to be deposited in the new Trust Fund effective July 1, 2011, assuming the proposed ordinance is adopted by the City Council no later than May 31, 2011.
- Employee contributions would continue to be deposited into the existing 401(h) account until a private letter ruling has been obtained from the Internal Revenue Service confirming that the employee contribution can go into the new trust on a pretax basis. A request for a private letter ruling will be filed as soon as the ordinance is approved. Retirement Services staff has indicated that the Federated employee contributions can continue to go into the 401(h) account for at least some portion of fiscal year 2011-12 without violating IRC Section 401(h). If, for any reason, a private letter ruling cannot be obtained before the limit will be reached, the City Attorney's Office and staff will return to Council with a recommendation on how to continue the ramp up to full funding.
- As long as the employee contributions continue to be deposited into the 401(h) account, employees who take a return of contributions from the Plan (usually those with less than 5 years of service) will continue to receive an extra payout amount from the pension fund in the amount of their contributions to the medical benefits account plus 2 % interest. After employee contributions start being deposited in the new trust fund, this extra payout will cease, as the Trust Fund and Pension Fund are two completely separate funds; and direct payment for qualified 115 trusts can only be made for health and welfare benefits.
- Retiree health premium payments would continue to be paid out of the medical benefits account until it is exhausted, unless the new Board of Trustees determines that some or all of the premium payment should be made out of the new Trust Fund. The purpose of this provision is to ensure that there is a default provision for ensuring that premium payments will continue to be made, while providing the trustees with flexibility for liquidating investments in the existing medical benefits account.
- The ordinance retains current Code language regarding the nature of the health benefit provided to retirees and other persons who receive retirement allowances from the Federated Plan (lowest cost plan premium for medical).
- The ordinance retains current Code language regarding contribution rates for medical and dental benefits (this section has been renumbered, but not altered).

### **EVALUATION AND FOLLOW-UP**

If approved by Council, the ordinance title will be published; the ordinance will be considered by the Federated board at its May 19, 2011 meeting; and the ordinance will be placed on the City Council agenda of May 24 or 31, 2011 for adoption.

### **POLICY ALTERNATIVES**

The City and employees cannot continue to ramp up to full funding for retiree health care within the existing Federated Retirement Plan structure. The 2009 agreements with the bargaining units specify that the City will establish a trust to implement the ramp up to full funding for retiree health care. For these reasons, other alternatives have not been considered at this time. As indicated above, if for any reason, a private letter ruling concerning the pre-tax status of employee contributions to the new trust fund cannot be obtained before the limit will be reached, the City Attorney's Office and staff will return to Council with a recommendation on how to continue the ramp up to full funding.

### **PUBLIC OUTREACH/INTEREST**

The draft ordinance was posted for public review prior to the Council meeting. The draft ordinance will be considered by the Federated Board prior to final consideration by Council and any Board or public comments made at that meeting will be provided to Council. The City Manager's Office of Employee Relations will also circulate the draft of ordinance to affected employee bargaining units for review and comment.

### **COORDINATION**

Preparation of this memorandum and the draft ordinance has been coordinated with the Department of Retirement Services, the Finance Department and the City Manager's Office of Employee Relations.

### **BUDGET REFERENCE**

N/A

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May 13, 2011

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**CEQA**

Not a Project; File No. PP10-068(b), Municipal Code or Policy.

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